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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

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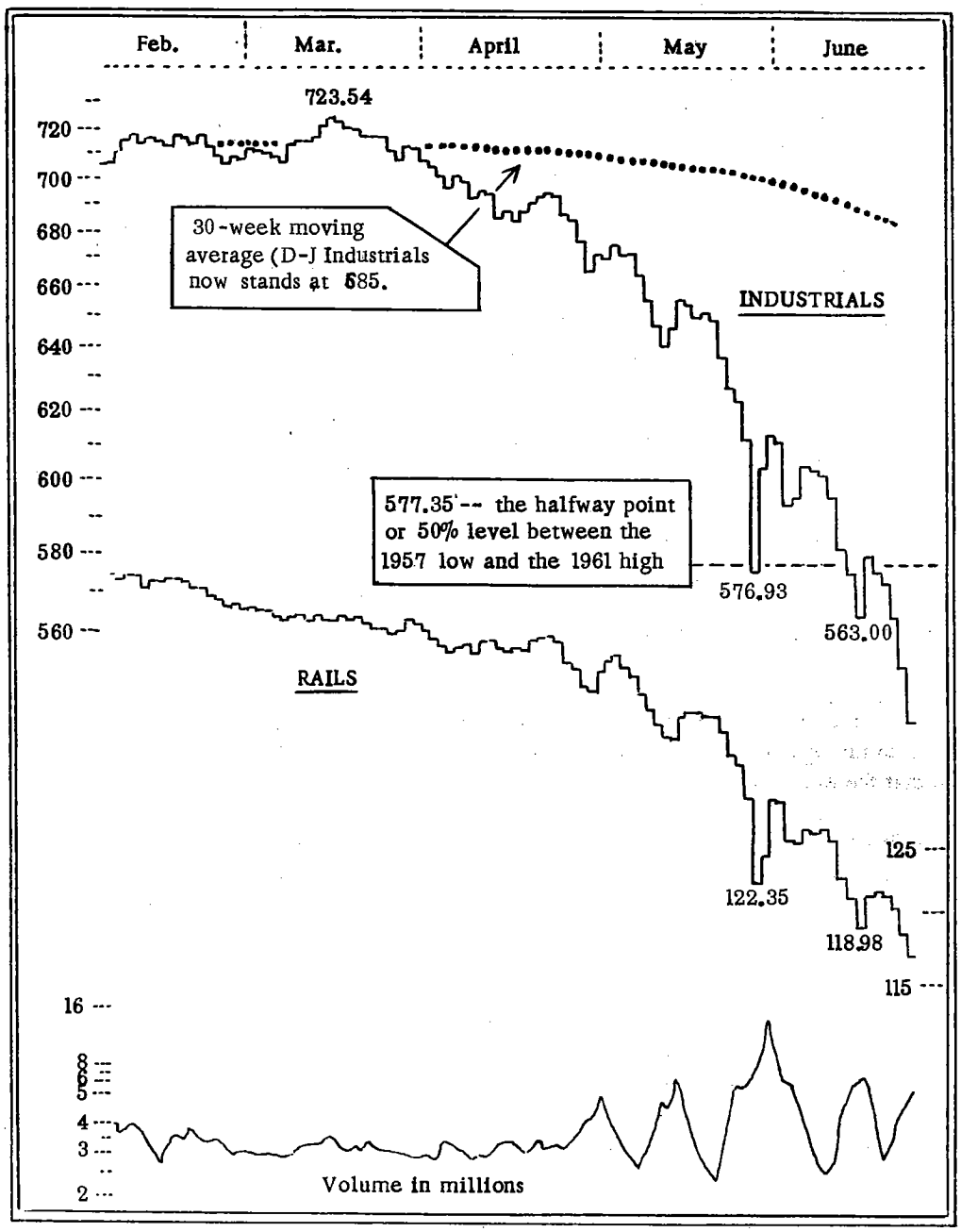
HISTORY REPEATS "Bear markets do not occur very often, but when they do, the majority of investment trusts, professional speculators and market advisors are bullish." Thus wrote Robert Rhea during the great collapse of 1937. He continued: "The role of the investment counselors is not an easy one. Generally they live too close to the market to see it clearly, and when customers, acting on advice, find themselves loaded with stocks in bear markets and demand an explanation, it is natural for the advisor to avoid admitting his error of judgment by blaming anything or anybody but himself. This has been true since I have watched the market -- it happened this time, and it will occur in later bear markets."

History has indeed repeated. Over the past few months we have heard "big business" blamed for "putting the market down" and therby punishing our President. Others are convinced that Mr. Kennedy, by his persistent anti-business meddling, has himself struck the market a death blow. Foreigners are blamed for dumping holdings on our American market, while many soothsayers (who were wrong on the trend) have stated that it was "the little fellow" who was responsible for the liquidation. In an effort to prove that all is well, newspapers describe every decline as "a flight by the small shareholder", while rallies are said to be "buying by mutual funds." Bear markets seem to generate absurd explanations, but this is as it should be; it is human nature to try to be optimistic in the face of calamity.

The unfortunate thing about bear markets is that they thrive on adversity. Bear markets resist diets of Presidential promises, planned budget deficits, growth projections, political vote-buying, optimistic statements by misinformed economists and Governmental spending sprees. Each night all the shares on the N.Y. Stock



 Exchange rest in the accounts of stockholders across the nation. As the downward trend continues, stockholders awaken to find themselves that much poorer. Values evaporate, and hopes, plans and dreams are quietly laid to rest.

THE MARKET For six months a bear market has been attempting to measure the extent of forthcoming deterioration in the American economy. The second leg of the bear market started in March and continues in effect as of this writing. On May 28 the Industrial Average struck a low of 576.93 on volume of 9.35 million shares -- which was huge selling pressure by any reckoning. Taking note of this action, Letters 183 and 184 warned subscribers that this type of volume is seldom (if ever) associated with the termination of a primary bear leg.

On June 13 the two Averages cracked the May 28 lows, and the last Letter (184) viewed this action as bearish as well. Moreover, Letter 184 emphasized the authority of the June 13 penetration, a penetration which took both Averages simultaneously below the May 28 lows to the accompaniment of expanding volume.

In an effort to keep subscribers solvent and "on the sidelines", recent mailings have called attention to fundamental differences between bull and bear markets. Many analysts (whose experience has been confined to bull markets) have been making a great to-do about the short interest and the odd-lot short totals. Again I will state that during a primary bear market, the short seller and the odd-lot short seller are "investing" with the primary trend. As such, these shorts must not be considered a great factor for technical strength; rather they should be seen as merely adding intensity to the periodic rallies which serve to correct the main downward movements. Despite this warning, many subscribers have been drawing bullish conclusions regarding the heavy odd-lot shorting and the large increase in the total short position (which now stands at 4.6 million shares). In an extended bear leg the short-sellers enjoy a unique distinction -- they are correct. Since most of today's investors do not remember or have never been in a great bear market, they assume that a large short position will necessarily end the decline. It will not -- in and of itself. "Let's face it," said a friend of mine with a wry expression, "the odd-lot shorts have done nothing but make money for the last three months."

As if to lend credence to the above observations, the market (following the release of the total short interest) broke the next day (June 21) in a vicious decline that took Industrials, Rails and the advance-decline ratio to new bear market lows. Thus, simultaneous penetrations by both Averages (on increasing volume) again reconfirmed the primary bear trend. Incredibly, the odd-lotters have remained persistently on the buying side during the latest decline. It is difficult to fathom how or why the public can remain bullish in the face of one of the worst periods of liquidation of the past century -- but that's what makes (bear) markets.

CONCLUSIONS As of this writing, the second leg of the bear market continues in effect. Its duration or extent cannot be predicted. It is the writer's opinion that we are now somewhere around the middle of the first psychological phase of the bear market. Stocks are currently selling minus a good deal of last year's "hopes and expectations", yet business has not given evidence of definitely turning down. The second phase of the bear market (if past history proves valid) will be the longest, and in that phase we can expect to see stocks go down in response to gathering recession or depression conditions in business. The first and second phases may not be separated by a secondary (upward) correction in the price structure, although such has usually been the case.

THEN AND NOW Historical comparisons are both interesting and instructive. I have charted the first two bear legs of the 1929-32 and 1937-38 bear markets with the action of the current bear market. The chart on page 3 is arranged in logarithmic form so that exact percentage of movement is shown. The time scale from the respective bull market peaks is also correct so that the exact rate of descent can be compared.

The first thing that strikes one is that the percentage of rise from the beginning of each bull market to the final bull market peak did not vary appreciably! The extent and duration of decline during the first two bear legs of each ensuing bear market show variations, however. Thus, the second leg of the 1929 bear market (352 to 198) wiped out 44% of the value of the Industrial Average in a period of less than two months. The second leg of the 1937 bear market (190 to 113) wiped out 42% of the value of the Dow, but the duration of the move was three months.

Referring to our own mess, the comparison (so far) is still a happy one. The second leg of the current bear market began in mid-March, 1962 at 723.54. By June 22 the Industrial Average had dropped to 539.19. Thus, in a period of three months the second leg of the bear market (and we do not know whether the second leg has terminated) has erased approximately 25% of the value of the Industrial Average. This means that the rate of descent during the current bear market's second leg is about half that which was seen during 1937. If the current second leg were to approximate the losses of the second legs during 1929 and 1937 (say a loss of 40%), we could expect the Dow to drop to around 410 before the next major correction.

The time scale on the chart shows that so far the current market lacks the violence (rate of descent) of the two preceding great

bear markets of this century. Nevertheless, if the current secondary leg continues, it is possible that the total extent of the decline will more closely approximate 1929 and 1937, even though the rate of descent is slower.

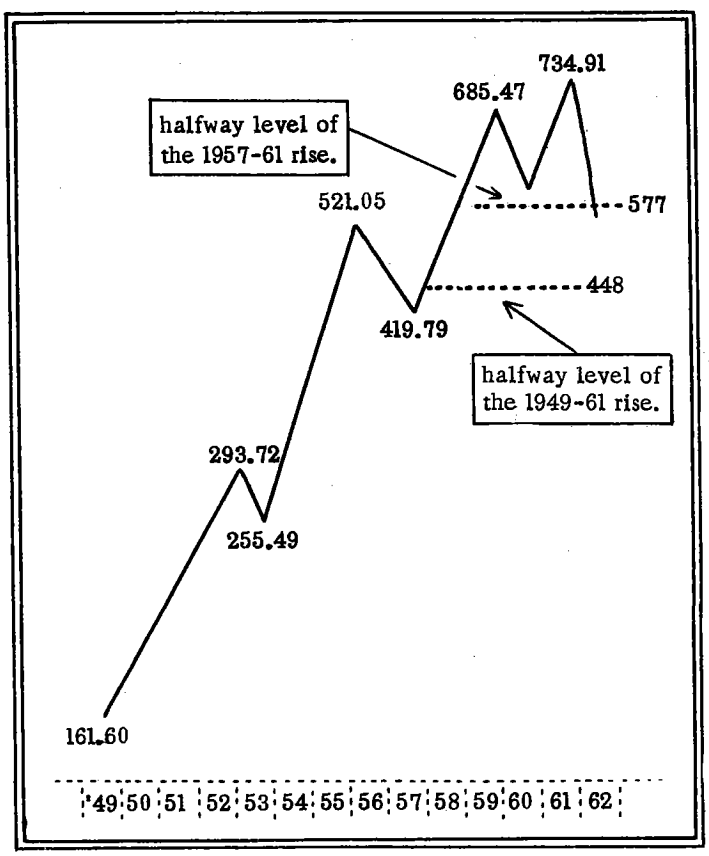
From the above, bulls can argue that based on 1929 and 1937 statistics (average duration of second bear legs -- two-and-one half months), time is running out on the current second bear leg. But bears can argue that if the current decline continues, it will simply mean that the downside action is going to be longer and more drawn-out this time.

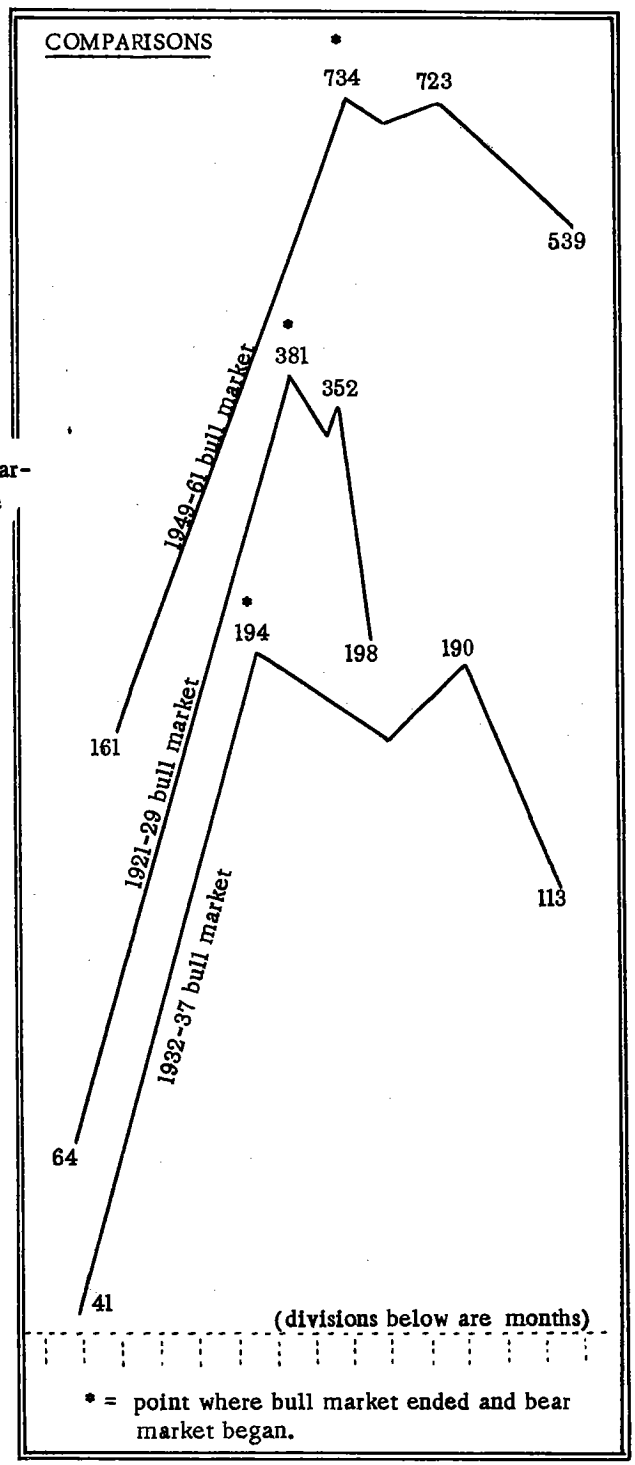
50% PRINCIPLE The last few Letters identified the 50% or halfway level of the 1957-61 (419.79 to 734.91) rise as 577.35. The action of the Industrial Average as it approached this critical point was most interesting. Note that the May 28 closing took the senior Average (chart on page 1) 42¢ below the halfway level. Then like a warrior who rises for a final thrust at his enemy, the Industrials rallied to 611.05. Following this rally, the Average plunged decisively below the halfway level. A final 15 point rise (June 15) touched the 50% level, but this rise proved the last gasp as the Industrials subsequently sank decisively under the 577.35 dividing line.

Under Dow's 50% Principle, the odds now favor an eventual approach or penetration of the 1957 low of 419.79. The two horizontal dotted lines on the accompanying chart identify the halfway level of the 1957-61 advance (577), and the halfway level (448) of the entire rise from 161.60 in 1949 to 734.91 in 1961.

If the 448 level is shattered, it will mean that the Industrials have been unable to hold half of the entire advance registered over the last thirteen years. Such a penetration would have extremely bearish implications. I will have a good deal more to say about this if and when the 448 level is broken.

SECONDARIES The Industrial Average has lost approximately one quarter of its total value in a period of six months. Whatever else may be said, we are now 190 points nearer a secondary (upward) reaction. Some of the phenomena which have proved helpful in identifying





 the start of a secondary correction in a bear market are as follows: (1) The two Averages may "get out of gear." As Rhea put it: "Industrials and Rails almost always stay in gear except when a change of direction is in the offing." At or near a bear market rally, one Average may refuse to decline while the other persists in its downward path. This may also take the form of --

(2) A non-confirmation. At important reversal points, one Average may break to a new low for the move while the other Average refuses to confirm. We saw an excellent example of this at the October, 1960 low when Rails refused by 14¢ to confirm a new low by the Industrial Average.

(3) Adverse news and general boardroom bearishness often accompany the termination of a bear swing. The beginning of bear market corrections have often corresponded with the release of unpleasant or even shocking news. "The press and the public are far more bearish now than sixty days ago," wrote Rhea during late 1937. "Worthwhile rallies in a bear market usually start when that condition prevails."

(4) At or near the low of a bear leg there is often a noticable resistance by many stocks to further decline. Thus the advance-decline ratio may refuse to confirm the downside action of one or both Averages, and this is usually accompanied by a pronounced contraction in daily new lows."

Perhaps the surest method of identifying a secondary correction (although this will not call the absolute beginning of the movement) is as follows: "A study of secondary reactions (advances) in bear markets will reveal the fact that the development of those movements is usually indicated by a series of minor rallies and declines, with each rally generally carrying above the preceding one, and declines terminating above immediately preceding lows. Such a formation in the Averages forecasts a secondary advance even though the primary trend is down." (Robert Rhea).

The above method will aid in identifying a secondary reaction which is already in progress. However, Rhea was not optimistic about the chances of forecasting the exact beginning of a secondary as the following quote suggests: "To play for a contra-trend movement of the daily variety, or to guess at the beginning of a secondary upswing in a bear market, is about on par with putting a bet on the '22' of a roulette layout. Both operations may be vastly profitable, but the odds are that they will not."

LATE NOTES On Friday (June 22) both Averages broke to new bear market lows to the accompaniment of increasing volume (5.6 million shares). As this Letter is completed (Monday, 10 A.M., June 25) prices have opened lower, and the market continues to probe the lower depths. Ironically, the Averages taken together with volume have never been easier to read. Both indicators have remained steadfastly in gear on the downside; volume classically contracts on rallies and expands on declines. All this notwithstanding, the majority of analysts still express surprise at each new break.

Now that the majority of stocks have lost on-quarter to three-quarters of their value, I am getting many calls asking whether "this is the time to short." My answer is that I haven't the slightest idea, but from the standpoint of pure tactics, one is not better late (in the market) than never. With Industrials down around 200 points, it strikes me that fresh positions on the short side can hardly be considered brillant (many subscribers have been in an all-cash position through the greater part of this collapse, and they consider this to be brilliant enough).

It is also well to remember that successive penetrations during a bear (or bull) market hold decreasing validity. Thus each downward penetration in the current leg is a prediction for lower prices -- but eventually there must be a final penetration which comes at or near the bottom of the leg. Adventures who put out shorts on this final penetration will then damn Dow's Theory because it did not produce another collapse. This type of operator is hopeless anyway, and neither Dow's Theory nor anybody else's theory will keep him from parting with his capital.

STOCKS Only the golds continue to act bullishly, with the great majority (98%) of all listed stocks in bearish trends. When the correction comes, the "big name" stocks will probably lead the parade on the upside. Many sophisticated traders will confine their purchases to those name stocks with a large (or steadily increasing) short interest.

NOTES A subscriber, Dr. Sloan Wilson, writes that he has a new market barometer. "When all our data goes off the bottom of the page as has recently happened, it is really time to sell."

I have prepared reprints of my June 4, 1962 Barron's article. This article was entitled "Track of the Bear." Subscribers who would like a copy please send a stamped, self-addressed envelop.